

Even though the inverse-elasticity pricing analysis was presented to the Commission in 1996,¹⁶ and was presented by the Commission to the Court of Appeals,¹⁷ none of the commenters have even attempted to address it. But failure to take conditions of demand into account will produce sub-market rates and the removal of payphones that competitive pricing, and a competitive market, would support. Hausman Decl. ¶ 32. This is precisely the state of affairs that Section 276 directs the Commission to avoid. Coalition Remand Comments at 23-24.

C. The Regulatory Cost Models Proposed by the Interexchange Carriers Are Inconsistent with the Requirements of Section 276

Unhappy with the results that a competitive market would produce, various carriers suggest replacing the Commission's judiciously selected market-determined methodology with an artificial, regulatory, cost-based approach.¹⁸ Nowhere, however, do they even make an effort to overcome the record evidence against, and the Commission's reasons for rejecting, such an approach. This is hardly surprising. Based on sound economic reasoning, the Commission

¹⁶ See, e.g., RBOC Coalition 1996 Comments at 16-17; RBOC Payphone Coalition Opposition to Petitions for Reconsideration at 7-8 (FCC Oct. 28, 1996); Strategic Policy Research, Economic Report on FCC Resolution of Payphone Regulatory Issues at 31-33 (attached to the separate 1996 comments of BellSouth Corp., CC Docket 96-128, July 1, 1996) ("SPR Report").

¹⁷ See Brief of Respondent FCC, et al., at 57 (D.C. Cir. Apr. 18, 1997) ("FCC Br.") (noting argument that "the use of the local coin rate as the measure of compensation for access code and other long distance calls would actually understate the market value of the use of a payphone for access code or other long distance calls, because of different demand elasticities for local and long distance calls . . .").

¹⁸ See AT&T Comments at 3-6; WorldCom Comments at 3; Frontier Comments at 8-9; Comments of the International Telecard Association at 5 ("ITA Comments").

repeatedly has concluded that a regulatory, cost-based approach is wholly inconsistent with Congress's mandate and the public interest.

First, and most important of all, relying on a cost-based methodology would drastically reduce the number of payphones available to the public. Any feasible, cost-based methodology must, by necessity, rely on average costs and average call volumes; one cannot very well calculate a cost-basis for each and every phone. Because costs and call volumes vary widely among providers, locations, and payphones, SPR Report at 26-27,¹⁹ any average costing method will lead to the removal of those payphones with less than average calling volumes or above average costs. See id. at 27. Consequently, payphones that would have been supported in a competitive market based on competitive pricing would be removed.²⁰ The results could be dramatic, especially in rural, higher cost, and low-volume areas. Andersen has estimated that, even at a default rate of \$.35, over 20 percent of all Coalition payphones are at risk of removal. And, for each penny that compensation falls below \$.35, thousands more will be eliminated. Coalition Remand Comments at 31; Andersen Remand Report at 13 n.15.

¹⁹ Arthur Andersen has calculated that, among individual Coalition members, the average cost per call can be as high as \$.34 per call for all calls (and as high as \$.37 per call for local coin calls) in some regions but only \$.28 per call (and \$.29 for local coin calls) in others. Andersen Remand Report at 13 n.14; see also Calculation of Per-Call Compensation and Review of Accounting and Regulatory Treatment for Payphone Asset Reclassification (attached to RBOC Coalition 1996 Comments) at 10 ("1996 Andersen Report") (average cost in the range of \$.30 per call). Moreover, independent PSPs, which often have different equipment, have wholly different cost structures than many LEC PSPs. Peoples Telephone Company, for example, has estimated that its average cost is \$.45 per call. See Report and Order, 11 FCC Rcd at 20564-65, ¶ 45.

²⁰ See RBOC Coalition 1996 Comments at 13-14 (incremental cost approach will result in a decline in payphone numbers that would "be contrary to congressional command"); RBOC Coalition 1996 Reply Comments at 12-13 (FCC July 15, 1996) (marginal cost approach would put PSPs out of business).

The Commission therefore was entirely correct when it concluded that “a cost-based compensation standard could lead to a reduction in payphones by limiting PSP's recovery of its costs, and this result would be at odds with the legislative purpose of Section 276 [to] 'promote the widespread deployment of payphone services to the benefit of the general public.’” Recon. Order, 11 FCC Rcd at 21267, ¶ 66. Nowhere do the interexchange carriers even attempt to respond to this appropriately-supported record conclusion.

Second, as the Commission also has recognized before, cost-based compensation poses obvious administrative difficulties and could well turn this otherwise competitive industry into a highly regulated one. As the Commission has explained, market-based methodologies “impos[e] minimal regulatory burdens on small new entrants.” FCC Br. at 49. In contrast, cost-based methodologies would require industry participants to follow regulatory accounting rules,²¹ and would embroil the entire industry in an unending series of periodic rate recalculations. The Commission therefore was correct to reject the costs of such a methodology as “completely disproportionate to any benefits offered by [the] approach.” Second Report and Order, Policies and Rules Concerning Operator Services Access and Pay Telephone Compensation, 7 FCC Rcd 3251, 3256, ¶ 32 (1992) (“Second Report and Order”). Once again, the interexchange carriers respond to these concerns by ignoring them.

1. *Sprint's Bellwether Approach Is Inconsistent with Section 276 and Would Be Harmful to Consumer Welfare*

Rather than address the Commission's reasons for rejecting a regulatory costing approach, Sprint attempts to resurrect the methodology by dressing it in competitive clothing. In particular,

²¹. Recon. Order, 11 FCC Rcd, at 21266, ¶ 66 (“it would be particularly burdensome to impose a TELRIC-like costing standard” -- or any cost-based standard -- “on independent [PSPs] who have not had previous experience with any costing systems”); Second Report and Order, 7 FCC Rcd at 3255-56, ¶ 32 (similar conclusion).

Sprint promotes a “bellwether” approach under which “the default rate [w]ould be based on the costs of handling non-coin calls by an efficient payphone provider.” Sprint Comments at 6; see generally Sprint Comments at 6-8. Based on this theory, Sprint urges the Commission to set per-call compensation based on the per-call cost calculated in a single cost study performed by New England Telephone (“NET”) for the Commonwealth of Massachusetts. Id. at 8-11.

The argument is flawed from its fringes to its core. For one thing, Sprint plucks its chosen result from the study without even bothering to explain the methodology employed. The reason for this is clear. Because of state regulatory rules, NET was required to submit an incremental cost study, which by definition omits large fixed, joint and common costs which otherwise should be included. See Andersen Remand Reply Report at 2-3. It is thus flatly wrong to assert that the study examined “total costs,” AT&T Comments at 12 (emphasis in original), or to claim that NET had an incentive to include “every conceivable” cost in its study, id. at 12-13; see Sprint Comments at 9. State requirements mandated that NET exclude non-incremental costs that, for per-call compensation purposes, should be included.

Indeed, relying on the NET incremental cost study is particularly inappropriate, as the Commission has expressly rejected such a methodology for per-call compensation purposes. As the Commission explained, it is wholly inappropriate to rely on a methodology -- like that used in the Massachusetts incremental cost study -- “under which a carrier is compensated only for the incremental cost of providing each service individually without a reasonable allocation of common costs.” Recon. Order, 11 FCC Rcd at 21268, ¶ 69 (emphasis added); see Report and Order, 11 FCC Rcd at 20576, ¶ 68 (“We conclude that use of a purely incremental cost standard for all calls could leave PSPs without fair compensation for certain types of payphone calls.”).

Such an approach “would not allow the carrier to recover the total costs of providing all of the services.” Recon. Order, 11 FCC Rcd at 21268, ¶ 69.

Even if reliance on incremental cost were permissible -- and it surely is not -- Sprint nowhere explains why an estimate of the incremental costs of providing service in Massachusetts should be used to determine compensation for PSPs that operate in rural West Virginia or Nebraska, where costs are higher and call volumes are lower. The statute requires the Commission to ensure that all PSPs are “fairly compensated” for “each and every call” made using their payphones. See 47 U.S.C. § 276(b)(1)(A). Nowhere does it state that the Commission can fulfill this obligation by offering compensation that is probably not adequate even in Massachusetts as the rate for PSPs located in higher cost, lower volume areas throughout the nation.

Indeed, because regional cost differences can be extreme, relying on cost estimates for a single state is singularly inappropriate. For example, compared to Massachusetts, nearby Vermont exhibits vastly higher per-call costs. Vermont line charges are *over double* those in Massachusetts, while Vermont call volumes are lower. Andersen Remand Reply Report at 3-4. Indeed, higher line charges than those borne by Massachusetts PSPs are common throughout the country; the average charge in BellSouth's region is 75 percent higher than the Massachusetts rate. Id.

Similarly, many regions exhibit lower call volumes, which also tends to increase per-call costs. Again, an examination of PSP costs in New England states alone proves this. Payphones located in New Hampshire carry only 70 percent of the average call volume of payphones in Massachusetts, and payphones located in nearby Maine and neighboring Rhode Island respectively average only 53 percent and 61 percent of the volumes in Massachusetts. Id. at 3-4.

As a result, if Sprint had selected nearby Maine rather than Massachusetts as its “bellwether,” the resulting cost per-call would have more than doubled.

The results of the Massachusetts incremental cost study thus are wholly unrepresentative of national costs. Among Coalition members, the average cost per call ranges up to \$.34 for all calls, and is in the range of \$.30 per call on average. Andersen Remand Report at 13 n.14; 1996 Andersen Report at 10. Independent PSPs have submitted average cost figures of \$.45 per call. See Coalition Remand Comments at 27 & n.14. Not one Coalition member reported regionwide costs as low as those reported by the Massachusetts incremental cost study. Andersen Remand Reply Report at 4.

Consequently, using the Massachusetts incremental cost study as a “bellwether” to set per-call compensation rates would produce insufficient compensation and trigger widespread removal of payphones, especially in rural areas with higher costs and lower volumes. This may be consistent with Sprint’s interests, but it is not consistent with the public’s interest or Congress’s express command. To the contrary, it would directly conflict with the Commission’s obligation to “promote widespread deployment” of payphones. 47 U.S.C. § 276(b)(1)(A).

It was precisely because of these considerations that the Commission decided to avoid reliance on a cost-based model and rely on market-based proxies instead. As the Commission explained, “a cost-based compensation standard could lead to a reduction in payphones by limiting a PSP’s recovery of its costs, and this result would be at odds with the legislative purpose of Section 276 [to] ‘promote the widespread deployment of payphone services to the benefit of the general public.’” Recon. Order, 11 FCC Rcd at 21267, ¶ 66. Instead, the Commission selected a “market-based approach” that would accommodate the “likely cost variations” from region to region and “payphone to payphone.” Id. at 21268-69, ¶ 71. Sprint’s

attempt to saddle the entire nation with cost recovery that would not even be sufficient in Massachusetts only underscores the wisdom of the Commission's choice.

2. *The Commission Appropriately Rejected Marginal and Incremental Cost Models as Inconsistent with Section 276 and Basic Economics*

Many of the carriers argue that marginal or incremental costs should be the basis for determining per-call compensation. See, e.g., LCI Comments at 5-6; CompTel Comments at 12; C&W Comments at 7. Under their theory, access code and subscriber 800 costs should not bear any of the joint and common costs associated with the payphone. For example, CompTel boldly asserts that "the existence of a payphone can be regarded as a given for the purposes of determining per-call compensation." CompTel Comments at 12. Likewise, Sprint argues that the Commission should prescribe a per-call compensation amount of zero, contending that the only costs created by dial-around and subscriber 800 calls are the "de minimis per-call costs of the additional wear and tear on the handset and the keypad." Sprint Comments at 4; see also LCI Comments at 6; CompTel Comments at 13.

The Commission, however, already has flatly rejected this approach. Recon. Order, 11 FCC Rcd at 21268, ¶ 70 ("a compensation rate of \$0 would not be in accord with our responsibility under the statute to ensure fair compensation for all payphone calls."); id. at 21268, ¶ 69 (rejecting incremental cost approach); Report and Order, 11 FCC Rcd at 20576, ¶ 68 (same). And the Commission's rationale was indisputable. Because a marginal cost approach does not allow PSPs to recover the joint and common costs which constitute a majority of all payphone costs, Recon. Order, 11 FCC Rcd at 21268, ¶ 69, it would give interexchange carriers a free ride at the expense of PSPs. It was precisely to end this free ride, and to replace no compensation with "fair compensation," that Section 276 was enacted.

Moreover, since a marginal cost approach does not allow for the recovery of joint and common costs, adopting such an approach would result in the removal of thousands of payphones. Indeed, as one of the interexchange carrier's own expert has explained, reliance on marginal cost in an industry with high fixed costs is not a recipe for fair compensation. It is instead a "recipe for bankruptcy." Strategic Policy Research, Critique of Hatfield Cost Analysis at 3 (attached to the 1996 Reply Comments of BellSouth (FCC July 15, 1996) (quoting Professor Baumol)) ("SPR Reply"); see also Comments of the APCC at 11 (FCC July 1, 1996) ("APCC 1996 Comments").²²

3. *The Commission Correctly Rejected TSLRIC and Similar Methodologies*

Several commenters advocate the use of TSLRIC, WorldCom Comments at 4; Comments of the Telecommunications Resellers Association at 18-19, or similar measures of "forward-looking, direct costs," LCI Comments at 7; CompTel Comments at 13 (same). But the Commission already rejected those models and -- despite vigorous appeals²³ -- the Court of Appeals has not disturbed the Commission's conclusions.

²² Sprint and MCI also argue, as they did before, that the Commission calculated PSP costs at \$.11 in 1992. See Sprint Comments at 10 & n.10; MCI Comments at 3. But the Notice of Proposed Rulemaking they rely on expressly states that the calculation that produced the figure was only an "example" and declares that the Commission was "not proposing" the figure as an appropriate rate. Report and Order and Further Notice of Proposed Rulemaking, Policies and Rules Concerning Operator Service Access and Pay Telephone Compensation, 6 FCC Rcd 4736, 4747-48, ¶ 44. Indeed, the Commission ultimately chose a rate in the range of \$.40 per call instead. See Second Report and Order, 7 FCC Rcd at 3257 ¶ 40. Nowhere do Sprint and MCI explain why the Commission's "example," which was rejected in 1992 in favor of a \$.40 rate, should suddenly be considered an accurate estimate of costs in 1997.

²³ Joint Brief of IXCs at 30 (contending that the FCC's "decision to treat deregulated rates as surrogates for costs" was flawed); id. at 36 ("the FCC's reasoning in rejecting TSLRIC is unsupported by the record, contrary to the FCC's other determinations, and thus arbitrary and capricious").

Indeed, the Commission's decision to reject these approaches was not only well-supported in the record, but undeniably correct. See, e.g., Recon. Order, 11 FCC Rcd at 21266-68, ¶¶ 66-69. As explained above, each of these cost-based approaches must rely on industry-wide averages and, as a result, simply cannot account for variations in costs and volumes from payphone to payphone and region to region. See id. at 21267, ¶ 66, 21268, ¶ 71; pp. 18-19, supra. Moreover, focusing on costs would mean a giant step backwards for this industry, which would be transformed from a highly rivalrous industry with multiple competing participants into an industry full of rate-regulated utilities. Recon. Order., 11 FCC Rcd at 21266, ¶ 66; p. 19, supra. It also would be a step backwards for the Commission, embroiling it in endless and complicated regulatory rate proceedings. See p. 19, supra. Even, before that process begins, the Commission will have to resolve disputes over the relevant model to define cost recovery. And, as the cost studies submitted by the participants in this proceeding demonstrate, there are as many ways of calculating costs as there are grains of sand on the beach.

In addition, to the extent these models -- like a pure marginal and incremental cost approach -- ignore joint and common costs associated with the provision of payphone service, they would be both inappropriate and unwise. As the Commission previously recognized, "a TSLRIC standard under which a carrier is compensated only for the incremental cost of each service individually without a reasonable allocation of common costs . . . would not allow the carrier to recover the total costs of providing all of the services." Recon. Order, 11 FCC Rcd at 21268, ¶ 69. As a result, they would neither provide "fair" compensation for each and every

payphone call nor “promote the widespread deployment of payphone services.” See id. at 21267, 21268, ¶¶ 66, 69.²⁴

D. The Carriers’ Cost Estimates Are Fatally Flawed

Consistent with their attempts to minimize per-call compensation through the use of inappropriate methodologies, various carriers have put into the record distorted cost estimates in order to “prove” that subscriber 800 and access code calls cost very little to originate. Neither these estimates nor the methodologies used to derive them have any validity.

1. *Reliance on the New England Telephone Cost Study Is Inappropriate*

Seizing on the results of the same incremental cost study Sprint relied upon for its fatally flawed “bellwether” approach, several commenters argue that the cost of originating calls is less than \$.16 or \$.17 per call. See ITA Comments at 6; Sprint Comments at 8-11; AT&T Comments at 12. But, as explained above, it is wholly inappropriate to rely on the results of this single Massachusetts incremental cost study to set a default rate for the entire nation. See pp. 21-23, supra. Indeed, as Arthur Andersen explains, far from being representative of costs, the results of

²⁴. Without addressing this analysis, or any other, some carriers assert that a TELRIC methodology would be best. But the Commission gave a particularly detailed set of reasons for rejecting the TELRIC methodology. In addition to the above reasons, the Commission explained that TELRIC was designed to “enable competitors to take advantage of an incumbent monopolist’s ‘economies of scale, scope, and density, and thus rapidly to acquire potentially bottleneck elements that they cannot promptly supply themselves.’” FCC Br. at 50 (quoting Recon. Order, 11 FCC Rcd at 21267, ¶ 67). Unlike local exchange facilities, payphones cannot even conceivably be construed as bottlenecks, and there are no significant economies of scope or scale. Recon. Order, 11 FCC Rcd at 21267, ¶ 67. Moreover, TELRIC can only be applied efficiently where there are few joint and common costs. For dial-around, subscriber 800, and all other payphone calls, however, almost all costs are joint and common. Ibid. This renders TELRIC particularly difficult and inappropriate to use for payphones. Ibid. Because these carriers offer nothing to controvert those conclusions or findings, there is no record (or any other) basis for reconsidering rejection of the TELRIC methodology.

that study are lower than the regional results for any Coalition member, and unrepresentative of even states in the New England region. *Id.*; Andersen Remand Reply Report at 3-4.

Moreover, the study does not even reflect the full costs for *Massachusetts*. As also explained above (*see* pp. 19-21, *supra*), the study does not look at "total costs" as AT&T asserts (at 12-13), but rather looks only at incremental costs, *i.e.*, the cost of meeting an additional increment of demand. It thus omits significant fixed, joint, and common costs. *See* p. 20, *supra*. The Commission already has indicated that, for per-call compensation purposes, relying on incremental costs alone is wholly inappropriate and understates the compensation to which PSPs are "fairly" entitled. *Ibid.* (citing and quoting Recon. Order, 11 FCC Rcd at 21268, ¶ 69 and Report and Order, 11 FCC Rcd at 20576, ¶ 68).

2. AT&T's Cost Study Offers a Wholly Unrealistic Estimate of Total Costs

Advancing what purports to be a direct cost methodology, AT&T argues that per-call costs are as small as \$.11 per call. But AT&T's "study" -- which does not show AT&T's actual costs per call as a PSP but rather at the costs of a hypothetical PSP -- is riddled with flaws. Indeed, the errors are so numerous that these Comments discuss only a select few; Arthur Andersen addresses the remainder in its Remand Reply Report (at 4-10).

The Costs of Providing A Payphone. AT&T begins by seriously underestimating the costs of providing a payphone. For example, AT&T assumes that a \$225 phone that it has used on occasion could be employed to provide coinless calls. *See* Robinson Affidavit at ¶¶ 5, 9, 20 (attached to Comments of AT&T). But of AT&T's 29,000 payphones, only 5,500 -- a small fraction -- are of the type AT&T uses for its "study." *See* Andersen Remand Reply Report at 5-6.

Thus, even though AT&T sanctimoniously claims that it is providing the Commission with real-world data drawn from its own payphone operations, it utterly ignores the costs incurred in acquiring the vast majority of its payphones. Indeed, given the technology AT&T recently has deployed -- many of its phones now have full-screen electronic displays -- it is not unreasonable to assume that most of its coinless phones cost many times the \$225 figure it uses. Ibid.

More fundamentally, AT&T's "study" inappropriately links per-call compensation to the cost of using a coinless rather than a coin phone. As the Coalition has pointed out, most payphones could not be supported unless they were capable of handling coin calls. Hausman Decl. ¶ 17; Andersen Remand Report 7-8; Coalition Remand Comments at 16-17. Because the coin equipment is "necessary" for the phone to exist at all -- and thus to be available for the subscriber 800 and access code calls from which carriers profit -- the costs of providing the coin equipment are joint and common, and thus properly allocable across all calls.

Indeed, AT&T's insistence on using coinless set costs is wholly disingenuous. After assuming the use of a coinless set, AT&T then also assumes that coin calls will be made from it, so as to average the costs of a coinless set across both coinless calls (which could be made from the set) and coin calls (which could not). In particular, after arriving at a total cost, AT&T assumes that the same 700 calls that would be made from a coin-capable set also would be made from a coinless set. Robinson Aff. ¶ 20. The assumption is false. At least 500 of the 700 calls per month AT&T builds into its calculation would be coin calls that cannot be made from a coinless set -- as revealed by the very source on which the Robinson Affidavit relies. See Andersen Remand Reply Report at 5 (citing APCC 1996 Comments at 5, (FCC July 1, 1996)); see also APCC Comments at 12-13 n.11 (criticizing prior AT&T "study" for making the same error). Adjusting AT&T's figures to account for this error alone -- with no other changes --

increases the average cost of calls from coinless sets from AT&T's proposed \$.11 to the more realistic figure of \$.45 per call. Andersen Remand Reply Report at 9.

Booth Costs. AT&T similarly includes an unrealistic estimate of providing an enclosure for the payphone. In particular, the AT&T estimate is based on a series of "assumptions" that are wholly unrealistic. (Indeed, the word "assume" appears in various forms no fewer than four times in the six sentences that make up the single paragraph addressing this issue.). In particular, AT&T's estimate is based on the cost of a "new and commonly used enclosure." Robinson Aff. ¶ 6. But many payphones will require a more expensive enclosure, especially those that require privacy, and those that are located outdoors. Indeed, it is especially telling, once again, that AT&T does not give its actual costs of providing these booths, but instead offers a hypothetical low-ball figure based on a series of unrealistic and unsupported assumptions.

Commissions. AT&T similarly excludes from its costs the commissions paid to location owners, asserting that they are "marketing costs." AT&T Comments at 15; Robinson Aff. ¶ 21. But AT&T's rationale for excluding commissions is preposterous.²⁵ Commissions are the price paid by PSPs for renting the paystation location from the location owner. Carriers like AT&T benefit from the location of a payphone just as much as PSPs do. It is the placement of a phone at that particular location that permits the carriers' customers to dial the revenue-producing calls in the first place. Consequently, just as it would be improper for AT&T to exclude the cost of

²⁵ AT&T asserts that excluding commission costs will eliminate the need for regulators to decide what is a "reasonable commission" and reduce upward pressure on commissions that would result from a guaranteed recovery. *Id.* at 15. Under cost-based regulation, however, the Commission is always required to determine what reasonable costs are. There is no more reason for the Commission to exclude commission costs to avoid this inquiry than there is for excluding the costs of the phone, the pedestal, or the enclosure. AT&T's objection thus does not provide a reason for excluding commission costs. Rather, it provides further record support for avoiding any cost-based inquiry and for relying on market proxies instead.

renting space for its personnel from an estimate of its costs, so too it is improper to exclude the cost of renting the paystation location from PSP costs. Andersen Remand Reply Report at 8.

Fixed Costs. AT&T's estimate also excludes innumerable fixed costs associated with the provision of payphone service. Nowhere does AT&T's estimate include the costs of accounting, finance, or customer support. Information systems and billing costs are excluded. Unless AT&T's payphone unit operates without the assistance of accountants, accounting, computers, and lawyers, AT&T's estimate is wholly unrealistic. *Id.* at 8.²⁶

Payphone Identification Costs. AT&T, despite its vociferous demands that PSPs pay for the costs of delivering ANI ii (or other identification) digits to it for the purpose of identifying calls that originate on payphones, see Coalition Remand Comments at 17-18, includes no LEC charges for this service. Depending on the technology employed, this will add somewhere between \$.01 and \$.11 per call. *Id.* at 17-18 & n.6; Andersen Remand Reply Report at 9 & n.23.

Number of Payphone Calls. The most egregious of AT&T's errors, however, comes from the call count. AT&T does not use actual call counts from its payphones to calculate per-call costs. Instead, as explained above, AT&T divides total call costs by the 700 calls that are made each month from independent PSP phones. See Robinson Aff. ¶ 20. With respect to Coalition smart and dumb payphones, however, that number is quite ambitious; actual Coalition call averages are closer to 500 calls per payphone per month. Andersen Remand Reply Report at 5.

²⁶ AT&T also suggests that the Commission should exclude line costs because "carriers contribute to such costs through the payment of access charges." AT&T Comments at 8 n.10. But this makes no sense. LECs no longer recover payphone costs through exchange access revenues. Moreover, even if one assumes that the access charges paid by interexchange carriers contribute to a reduction in the amount LECs charge all users for lines, the amount each PSP in fact does pay remains a legitimate and unavoidable cost of providing payphone service.

More fundamentally, the number is wholly unrealistic when it comes to coinless phones. Of the 700 calls per month reported by independent PSPs, fewer than 200 were coinless calls that could be made from a coinless phone. *Ibid.* APCC Comments at 13 n.11. As a result, AT&T's cost estimate for coinless calls from a coinless payphone must be adjusted by dividing total call costs by less than 200, rather than 700, calls.

The Bottom Line. If AT&T truly wished to provide the Commission with appropriate evidence, it would have provided the Commission with its actual costs, based on the equipment it actually uses, the personnel it truly employs, the overhead it in fact supports, and the call counts genuinely generated by its payphones. But AT&T did not do this, and with reason: AT&T's actual per-call costs, when properly measured, exceed the deregulated, competitive local coin rate currently used by the Commission as a proxy.

Indeed, once the errors in AT&T's hypothetical study are corrected to incorporate realistic costs and plausible call counts, it produces per-call costs of \$.40 to .41 per call (for smart and dumb sets) and \$.84 per call (for coinless phones). Andersen Remand Reply Report at 9. AT&T's study thus does nothing to prove that dial-around and subscriber 800 calls should be priced lower than local coin calls. To the contrary, it -- like every other proper cost or market-based study submitted in this proceeding -- demonstrates that per-call compensation must exceed the local coin rate.²⁷

²⁷ Mr. Robinson's "top-down" approach (Robinson Aff. ¶ 21) is similarly flawed. It is based the same on erroneous (and purely hypothetical) cost estimates as the rest of his analysis. Moreover, it uses a cost "allocation" methodology that fails to accord with any known or accepted cost-accounting principle or rule; indeed, the methodology is preposterous on its face. As Andersen explains, the methodology arbitrarily increases per-call costs based on increased call volumes but fails to account for those increased volumes when allocating total costs among call types. Andersen Remand Reply Report at 10 & n.25. Using proper, established cost allocation principles, Andersen calculates that coinless calls, on average, cost only 4 cents less per call to originate than local coin calls (if one excludes uncollectible costs, interest costs, and

3. *The Commission Should Reject the Discredited Hatfield Study Advanced by MCI*

MCI dredges up its discredited study by Hatfield Associates, Inc., which purports to show a high-end cost estimate of 8.3 cents for access code calls (excluding 800 calls). Even setting aside the inherent flaws in relying on a single average or estimated cost,²⁸ this study is fundamentally flawed, both in conception and execution, as the RBOC Payphone Coalition and others demonstrated back in 1996. See C. Geppert, Critique of MCI's Use of the Hatfield Study and Other Issues at 1 (attached to 1996 RBOC Coalition Reply Comments) ("1996 Andersen Reply Study"); see SPR Reply at 7 (Hatfield's "arithmetic sleight-of-hands (at pp. 4-5) constitute a veritable *tour de force*.").

potential ANI ii costs). Id. at 10 n.25; Andersen Remand Report at 13. If uncollectible costs, potential ANI ii costs, and interest costs are included, the average cost per call for coinless calls exceeds the cost for local coin calls. Andersen Remand Reply Report at 10 n.25; Andersen Remand Report at 13. We should also note that Mr. Robinson's estimate overstates the cost of local usage charges. As the Coalition has demonstrated, most PSPs do not incur such charges. Nonetheless, AT&T's calculation charges local usage against all PSP coin calls by attempting to allocate a portion of flat-rate line costs to local usage. But this is both incorrect and backwards. It is incorrect because avoided cost analysis must look to the costs as PSPs actually incur them, not as AT&T would like PSPs to incur them. And it is backwards because, rather than allocating a portion of flat-rate costs to local usage, it makes more sense to allocate local usage charges back to total line costs. The Commission has concluded that basic line costs are generally fixed rather than volume sensitive. See First Report and Order, Access Charge Reform, FCC No. 97-158, CC Docket No. 96-262, at 12, ¶ 24 (May 16, 1997) (from cost-causation perspective, most of the cost of the local loop is not usage sensitive, even though some costs are recovered through a per-minute charge). Under this view, it is not the case that flat-rate charges are used to cover the costs of local usage; instead, it is that local usage charges are used to defray non-usage sensitive, flat costs.

²⁸ For example, the Hatfield study focuses on the cost of installing and maintaining one additional payphone and then divides that amount by the average number of calls per payphone. See C. Geppert, Critique of MCI's Use of the Hatfield Study and Other Issues at 1 (attached to 1996 RBOC Coalition Reply Comments); SPR Reply at 2. But, under any plausible distribution of payphone usage, at least half of all payphones are used less than average. Thus, even if the Hatfield study calculated costs correctly (and, as we shall see, it does not), half of all payphones would receive compensation less than their costs. This would lead to the immediate removal of many payphones.

As NYNEX demonstrated when MCI first introduced the study, see NYNEX Reply Comments, CC Dkt. No. 91-35 (FCC Oct. 31, 1995), the Hatfield study very selectively incorporates data from a 1993 New Hampshire cost study conducted by New England Telephone. The New Hampshire study examined the costs of providing indoor and outdoor coinless and coin payphone service as well as coin semi-public service in New Hampshire. In developing its per-call cost of 8.3 cents, however, MCI only used the data on the cost of providing coinless phones indoors. This cost was \$300.39. 1996 Andersen Reply Study at 2; SPR Reply at 7-8. Indoor coinless payphones, however, represent only 5.9% of the entire New Hampshire payphone base. Taking outdoor payphones into account, the average cost for all coinless payphones goes up to \$590.52, nearly twice the cost utilized by MCI.

To compound matters, the Hatfield study shows maintenance costs of \$38.18 per phone. Again, this is the cost for maintaining indoor coinless payphones. 1996 Andersen Reply Study at 2. For all payphones in New Hampshire, the maintenance cost was \$166.05 per phone in 1993. Id. Even this higher figure is still much too low, however, because maintenance and vandalism costs on payphones in urban areas, like New York, are much higher than in rural areas, like New Hampshire, and there are many more phones in urban than in rural areas. Id.; SPR Reply at 9.

In addition, the Hatfield study selectively incorporates data from New Hampshire in certain instances, and data from national sources in others. SPR Reply at 9. For example, the study uses \$320 per year as the cost of a business line. In New Hampshire, the actual cost is \$525 per year. 1996 Andersen Reply Study at 2. Still other costs, such as new line costs, must be included to develop any per-call compensation in this proceeding. Ibid.

Finally, the Hatfield study also repeats many of the same egregious errors as AT&T. Like AT&T, the Hatfield study excludes the costs of commission payments. Id. at 3; SPR Reply at 3-

5. Also like AT&T, the Hatfield study excludes costs associated with coin phones from the numerator of its per-call equation, while including coin calls themselves in the denominator. SPR Reply at 8; 1996 Andersen Reply Study at 3. In other words, just like AT&T, the Hatfield study spreads the cost of coinless phones over all calls, including coin calls. This is flatly dishonest. See SPR Reply at 8-9.

Each of these flaws has been pointed out before -- and in greater detail. Yet MCI makes no effort to correct them at all, and with reason: Once those flaws are corrected, the Hatfield study shows per-call costs averaging at \$.31. See 1996 RBOC Coalition Reply Comments at 14-15. Even this figure is understated, as it does not include a correction for Hatfield's erroneous call counts, and it does not include tariffed rates for ANI ii digit transmission. If these corrections are included, even MCI's hypothetical model yields per-call costs that equal or exceed the prevailing competitive local coin rate.

4. *If the Commission Relies on Costs -- Which It Should Not -- It Must Look to the Costs Incurred by Actual PSPs*

In contrast to AT&T's and MCI's cost estimates for hypothetical PSPs, studies of the actual costs incurred by PSPs -- using appropriate methodologies -- show that average costs realistically are in the range of and often exceed competitive local coin rates. This is true not only of the Andersen study submitted by the Coalition, see Coalition Remand Comments at 30; Andersen Remand Report at 13 & n.14; 1996 Andersen Report at 9-10, but also of cost studies performed by independent PSPs as well. For example, Communications Central Inc. submitted data indicating that "there is currently little cost differential between local coin calls and dial around calls generated from CCI's payphones." CCI Comments at 10. CCI submitted data demonstrating that its costs of providing a coin call were \$0.37, while the costs of originating a dial-around call were \$0.34. These dial-around call costs exclude, however, any administrative

costs associated with collecting per-call compensation, which CCI anticipates will “escalate dramatically for PSPs.” Id. at 12. Similarly, Peoples Telephone Company submitted evidence that the costs of originating dial-around calls are \$0.36. Peoples Comments at 14. And the APCC estimates that the average cost of carrying any type of payphone call is \$.41. APCC Comments at 15.

Since these studies are submitted by actual PSPs, they provide the most accurate picture of actual payphone costs. For that reason, should the Commission select a cost-based approach -- which it should not -- the starting point of the Commission’s analysis should be the data submitted by the independent PSPs and the cost study performed by Arthur Andersen, not a single, sealed study applying an inappropriate incremental cost methodology to payphone costs in a single unrepresentative state, Sprint Comments at 10, or the hypothetical costs incurred by non-existent PSPs. See Midcom Comments at 7 (recommending “that the Commission direct the PSPs -- who are in a position to provide the necessary information -- to provide cost data”).

At bottom, however, the divergent results of the hypothetical and actual cost studies demonstrate the inherently flawed nature of a cost-based approach. Average cost-based measures cannot account for the extent to which payphone costs and payphone volumes differ from payphone to payphone and region to region. They embroil the Commission in unnecessary disputes over cost-allocations and calculations like those seen in this proceeding. They saddle competitive but often small PSPs with the burdens of regulated utility cost accounting. And they inevitably will produce sub-market compensation in some areas, causing the removal of payphones in direct contravention of Section 276’s express commands.

Instead, the Commission should continue to rely, as it has in the past, on competitive market-based outcomes, with any appropriate adjustments, see pp. 13-17, supra, that are

supported in the record. As the Commission repeatedly has recognized, the market is best situated to determine how much compensation is "fair" and to ensure efficient deployment of payphones. Here, the market would price dial-around and subscriber 800 calls above -- at least \$.07 above -- the prevailing, competitively established local coin rate. Because this is not only the fair but the efficient result, the Commission should do so as well.²⁹

II. The Commission Must Ensure the Payment of Appropriate Interim Compensation by Those Carriers Who Benefit from Payphone Usage

Having convinced the Court of Appeals to remand the Commission's interim compensation mechanism, the interexchange carriers bore an obligation on remand to suggest a replacement that could meet the objections that they themselves raised on appeal. Far from attempting to meet that obligation, however, the interexchange carriers have abandoned it, disowned it, and ignored it. Pursuing its unbridled self interest above any notion of principled decisionmaking or argument, each carrier seems to propose a methodology that will foist a portion of its obligations onto others or -- more shamelessly still -- eliminate its responsibilities for payment altogether. But none of these proposals are fair. None are rational. And none meet the requirements that the Court established for remand.

This unprincipled approach to the remand issues is, unfortunately, characteristic of the behavior of interexchange carriers when it comes to interim compensation. Large and small

²⁹ AT&T also argues that allowing the per-call compensation rate to vary with the local coin rate increases its administrative costs of providing compensation. AT&T Comments at 16-18. AT&T's estimates, however, are grossly exaggerated; most of the costs could be reduced greatly through the use of a centralized data collection center and clearing house. Moreover, in the event AT&T believes that the expense of monitoring rates is too great, it can negotiate with PSPs for a uniform rate, or agree to pay all PSPs based on one of the higher local coin rates. In any event, AT&T's trumped-up costs are no basis for using an average cost model that will not support competitive payphone deployment in rural and high cost areas, in contravention of Congress's express commands. If the Commission must establish a single, default rate for the entire nation, it must use one that will support payphones in rural, high-cost areas.

carriers alike, before the Court of Appeals' decision and after, have openly flouted the Commission's orders and refused to pay PSPs the compensation which they are owed. They have refused to pay even after accepting the benefits of the reduced carrier common line charge that resulted from the very same orders.³⁰ They have refused to pay even after raising their rates to customers for the stated purpose of being able to pay.³¹ And they have refused to pay even after denouncing the Commission's orders, and blaming price hikes on the Commission, before

³⁰. For example, AT&T and MCI have sent letters to all LECs, indicating that they will not pay. See, e.g., Letter from Randy Deutsch, AT&T, to Marlin Ard, Pacific Bell, May 5, 1997 (refusing to pay absent state "certification" of compliance); Letter from Michael Beach, MCI, to Laura Murdock, Pacific Bell, May 1, 1997 (demanding certifications). Even though most Coalition members have certified their compliance, these carriers still refuse to pay.

³¹. John Rendleman, "800" Data Toll Hike Hits Users, CommunicationsWeek, Aug. 18, 1997, at 1 (reporting that AT&T, MCI and Sprint all had raised their rates by between 6 and 7 percent for the alleged purpose of paying per-call compensation); APCC Comments at 23-24 & Attachments 6-15 (showing tariffs for increased rates); Bill Pietrucha, AT&T Hikes Payphone Calls To Offset FCC Plan Costs, Newsbytes, May 30, 1997 (quoting AT&T personnel as stating that they do "not intend to profit" from rate increases and asserting that they "are simply passing on the charges being levied by the Fcc."); AT&T Adjusts Consumer Prices to Offset New Payphone Costs -- Company Appeals FCC Order, Business Wire, May 30, 1997 (similar quotes); Price Hike: AT&T Adjusts Business Long-Distance Prices To Offset New Payphone Costs, EDGE, May 5, 1997 (same); see also FCC Is Turned Back In Plan to Reimburse Pay-Phone Operators, Wall St. J., July 2, 1997, at B2; AT&T Plans to Charge An Extra 35-Cent Fee For Some Payphones, Wall St. J., June 2, 1996, at B6.

the public and the press.³² Seldom has such willful and arrogant disobedience of Commission orders been exhibited so clearly by so many.

Consequently, in addition to setting forth the terms for interim compensation, the Commission's orders on remand must also make sure that carriers actually pay. Overdue payments should be recoverable with interest, and further willful disobedience should be met with stiff penalties and appropriate sanctions.³³

A. The Commission Cannot Abandon Its Interim Compensation Mechanism

Several carriers urge the Commission to give up on interim compensation altogether. See WorldCom Comments at 4-6; CompTel Comments at 14-15; Frontier Comments at 10, 13-14; see also Comments of Airtouch Paging at 4-5 (requesting that Commission eliminate interim compensation for 800 calls). According to these carriers, the Court of Appeals "vacated" the Commission's interim compensation requirements and, as a result, any new interim compensation scheme would take effect only for the few days between final decision and

³² See, e.g., John Rendleman, "800" Data Toll Hike Hits Users, CommunicationsWeek, Aug. 18, 1997, at 1 (quoting AT&T director of toll-free services John Cushman as stating that "problem was that the FCC's compensation rates were exorbitant. Our only option was to increase our rates across the board knowing some customers would be unfairly penalized."); Richard Mitchell, The Squeeze on Phone Cards, Credit Card Management, July 1997 (quoting Sprint spokesperson as blaming the FCC for putting "an undue burden on the industry and ultimately the consumer"). Articles on this issue, obviously promoted by the interexchange carriers, also appeared throughout the national press. See, e.g., AT&T Plans to Charge an Extra 35-Cent Fee For Some Payphones, Wall St. J., June 2, 1996, at B6; AT&T Adjusts Consumer Prices to Offset New Payphone Costs -- Company Appeals FCC Order, Business Wire, May 30, 1997 (similar quotes); Price Hike: AT&T Adjusts Business Long-Distance Prices to Offset New Payphone Costs, EDGE, May 5, 1997 (same); FCC Is Turned Back In Plan to Reimburse Pay-Phone Operators, Wall St. J., July 2, 1997, at B2.

³³ With respect to one issue, however, there is no dispute. Each and every carrier (excluding those that urge the Commission to abandon interim compensation altogether) seems to agree that the amount of total interim compensation should be calculated using the Commission's prior methodology. In particular, the carriers seem to agree that the Commission should multiply the per-call compensation rate it calculates by the average number of compensable calls per payphone per month. See, e.g., AT&T Comments at 19-20.

October 7, 1997. This, they contend, would not be worth the Commission's time. See CompTel Comments at 14-15; WorldCom Comments at 4-6; Frontier Comments at 11-14; see also MCI Comments at 6 (given that "the interim period is almost over, the Commission should simply abandon an interim compensation scheme").

This argument, however, proceeds from a false premise. The Court of Appeals did not "vacate" the Commission's interim compensation rules. To the contrary, as the FCC already concluded in its remand notice and explained to the Court of Appeals, the Court *only* remanded those portions of the orders dealing with interim compensation; nothing in the Court's order vacates them.³⁴ As a result, the Commission's interim compensation regime remains in effect, and it most certainly is worth the Commission's time to ensure that the interim compensation burden is both appropriately calculated and fairly allocated.

Other carriers argue that -- while Congress set an express deadline for the promulgation of regulations to implement the compensation requirement -- it made "no demands on when compensation was to begin," C&W Comments at 12; see WorldCom Comments at 8 n.7; see also MCI Comments at 6. From this, they conclude that the Commission is free to do away with interim compensation altogether. This argument is absurd. Surely the requirement that the regulations be promulgated by a date certain also includes an implied requirement that they also become effective. Indeed, under the theory espoused by these interexchange carriers, the

³⁴See Remand Notice at 1-2 ("[E]xcept for the vacated asset valuation standard, all of the requirements of the *Payphone Orders* -- including those portions that were remanded to the Commission -- remain in effect pending further action by the Commission on remand."); Response of the FCC to Motion for Clarification or, in the Alternative, Rehearing, No. 96-1394, at 8 (D.C. Cir. Aug. 22, 1997) ("The Court did not say that it was vacating those portions of the orders. The Commission's understanding that the Court left the remanded provisions in effect -- and that the absence of language vacating the provisions was not simply an oversight -- is reinforced by the fact that the Court expressly did 'vacate' one narrow portion of the payphone orders.").

Commission could have promulgated regulations immediately, but set compensation to begin in the year 2020. Such an approach simply cannot be squared with the strict deadlines Congress set forth for Commission action. Nor can the arguments in favor of abolishing interim compensation altogether.

Besides, any suggestion that interim compensation be abolished is wholly at odds with the express language of the statute and any notion of fundamental fairness. Pursuant to the Commission's orders, as of April 15, 1997 LECs eliminated hundreds of millions of dollars in subsidies (state and federal) formerly used to support their payphones. Already having reaped the benefits of that change in the form of reduced access charges, interexchange carriers are now arguing that LECs should be denied the per-call compensation that was supposed to replace those subsidies. This is not only grossly unfair, but directly contrary to the language of the statute. Section 276(b)(1)(B) expressly states that the Commission must eliminate the then-existing subsidy systems "in favor of" a system of fair compensation. It simply does not allow the Commission to eliminate the subsidies "in favor of" no compensation at all.

Indeed, the proposal that interim compensation be eliminated flies in the face of yet another statutory command -- that PSPs be compensated for "each and every" completed call made using their phones. 47 U.S.C. § 276(b)(1)(A). If interim compensation were abolished, six months of LEC PSP calls would go entirely uncompensated, in direct and irreconcilable conflict with Congress's express command. As the Commission has pointed out, the Court of Appeals remanded portions of the Commission's opinion for failing to provide per-call compensation on a few classes of calls during the interim period. Remand Notice at 2 n.3. Clearly the Court of Appeals would find equally unacceptable a decision that, rather than excluding a few classes of calls, eliminated compensation during the interim period entirely.

At bottom, the interexchange carriers are asking the Commission to award them an unwarranted windfall. They have saved hundreds of millions in access charges. They have raised their rates for the stated purpose of paying per-call compensation -- and openly blamed the Commission for their rate hikes -- but refused to pass any of that money on to the PSPs for which it allegedly was collected. Now, having flouted the Commission's orders, they ask the Commission to ratify their misconduct by canceling interim compensation. Such willful misconduct is not the sort of behavior that should form the basis for favorable action by the Commission. To the contrary, it is precisely the sort of conduct that should be met with fines and sanctions.

B. The Commission Cannot Base LEC Obligations on Total LEC Toll Revenues

Although some carriers have distanced themselves from the absurd notion that interim compensation should be eliminated altogether, none have managed to suggest a system that will fairly allocate the burdens among carriers. To the contrary, instead of seeking a methodology that will allocate burdens based on the benefits received from subscriber 800 and access code payphone calls, as the Court of Appeals required, each interexchange carrier has proposed a methodology that minimizes its own share of the burden.

1. *AT&T and MCI's Proposal that LECs Be Assessed Interim Compensation Obligations in Proportion to Total Toll Revenues Cannot Be Squared with the Court of Appeals' Holding*

Perhaps the most surprising and most egregious proposal is that put forth by AT&T and MCI. According to AT&T and MCI, the Commission must use total toll revenues to allocate the obligations of interim compensation obligations. See AT&T Comments at 20 ("allocating the interim compensation obligation on the basis of the toll revenues of all toll carriers -- including LECs -- is the only approach . . . "); MCI Comments at 6-7 ("the Commission could determine